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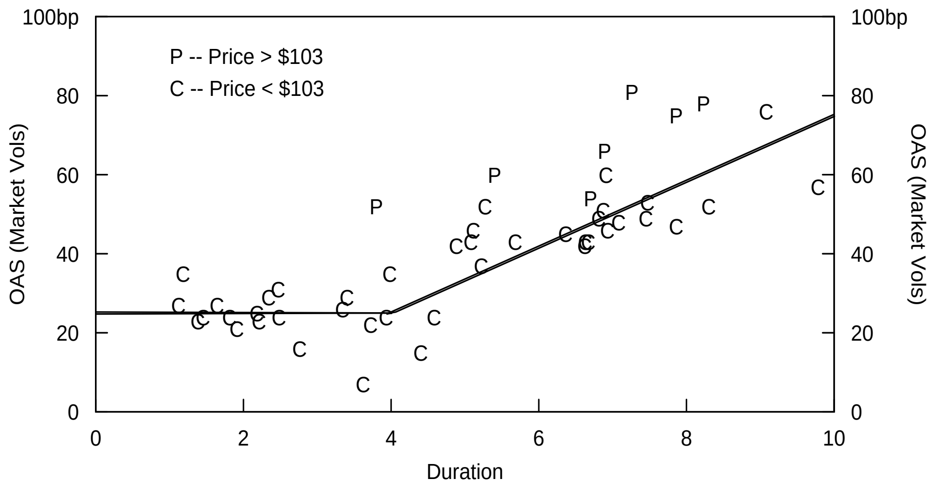
Examining Agency and Nonagency CMO OASs

In the agency and nonagency CMO markets, better relative value is often found in longer-duration tranches. New-issue transactions, although richer than secondaries, generally show the same pattern. In this section we will take a brief look at OASs in the agency and nonagency CMO markets, and illustrate the sectors that investors can exploit to outperform the index in 1997.

Trade strategies become evident when observing OASs in the agency CMO market. As shown in Figure 3, OASs of agency CMOs in the secondary market are level for durations four years or less, then ascend sharply through year ten. Many short-duration PACs and sequentials trade around 25bp OAS (market implied volatility), due, in part, to strong bank demand. For durations greater than four years, a steep upward sloping curve is observed. In general, premium CMOs trade at wider OASs than comparable tranches with lower prices, an inefficiency usually not evident in the pass-through market. To take advantage of the agency CMO OAS curve, consider "roll-down" trade strategies against duration-matched pass-throughs and Treasuries. In addition, longer-term investors can pick up OAS in premium agency CMOs and outperform comparable pass-throughs.

Figure 3. Agency CMO OASs Versus Effective Duration, Selected PAC and Sequential Issues, Dec 96

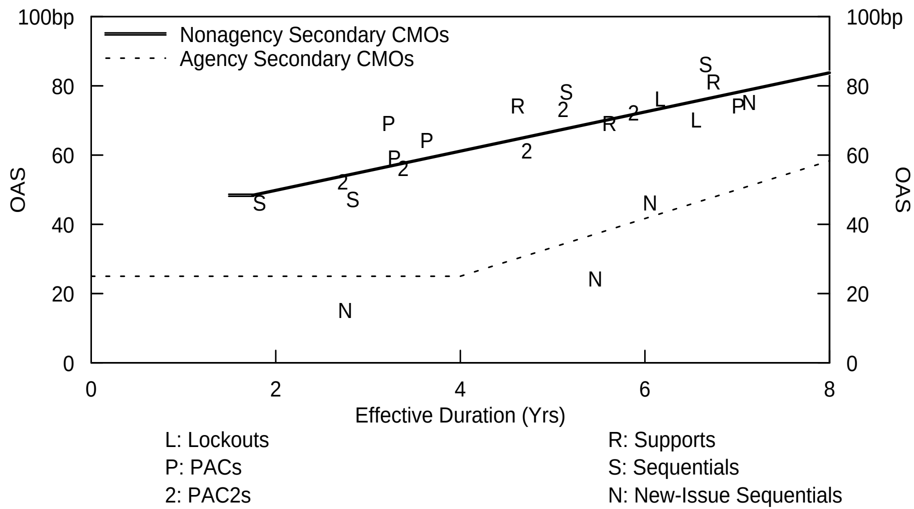


Source: Salomon Brothers Inc.

The OAS advantage in nonagencies is found in several sectors, and will likely outperform the index in 1997.

The nonagency CMO OAS curve highlights additional opportunities for mortgage investors. As shown in Figure 4, we plotted the OAS for secondary, as well as new-issue, nonagency CMOs. In addition, we show the agency CMO OAS curve from Figure 3. A few conclusions are immediately evident. First, secondary nonagencies offer wide OAS advantages over secondary agency CMOs (as represented by the dotted line in Figure 4). Particularly at the four-year duration point, the OAS differential is dramatic. Second, nonagencies traded in the secondary market offer wider OAS advantages over new-issue nonagency CMOs (labeled "N") for the short- and intermediate-duration tranches. However, long-duration, new-issue nonagencies continue to offer better value. Third, the OAS advantage of secondary nonagencies is not limited to any one tranche type, encompassing PACs, supports, sequentials, and lockouts. Value in the secondary nonagency market is in step with our theme that selected non-index mortgage products are likely to outperform the index in 1997. As such, we continue to recommend de-levered cash flows (PAC2s, components, or supports), as well as prepayment lockout bonds, for wide OAS and good call protection.

Figure 4. Significant OAS Advantage in Secondary Nonagencies



Source: Salomon Brothers Inc.

Mortgage Strategy Conference Call

On Thursday, January 9 we conducted a mortgage strategy conference call in which we discussed the previous strategies in more detail. The conference call can be replayed until January 18. The phone number is 800-964-4597, passcode: 4597. A supplemental chart package is available from your Salomon Brothers sales representative.